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BEFORE THE ARIZONA CORPORATION C

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY
FOR AN AFFILIATE AGREEMENT WITH
AMERICAN WATER RESOURCES, INC.

Docket No. WS-01303A-05-0170

STAFF'S CLOSING BRIEF

I. Introduction.

Arizona American Water Company ("Arizona American") provides water and/or sewer service to over 121,000 customers in Arizona. American Water Resources, Inc. ("AWR") and Arizona American are subsidiaries of American Water Works Company whose ultimate parent is RWE AG, a company organized under that laws of the Federal Republic of Germany. According to the 2000 Annual Report of American Water Works Company, AWR was formed in January of 2000 "to offer water and wastewater related products and services to residential, governmental or business consumers." Essentially, AWR offers customers insurance for problems in the customer-owned water and sewer service lines between the customer's house and the utility company's meter. Direct Testimony of Linda Jaress, Staff Exhibit S-5, p. 2.

In this case, Arizona American seeks authority to enter into an agreement ("the Agreement") with its affiliate AWR to offer an insurance product for Arizona American's customers' water and sewer service lines. AWR has instituted similar water and sewer line insurance programs in eleven other states. The programs are the first of their kind offered to utility sewer and water customers in Arizona. S-5, p .2.

The Agreement provides terms and conditions under which Arizona American would provide certain services to AWR related to AWR's Water and Sewer Line Protection Programs ("Programs"). For \$60 per year, the customer would receive insurance from AWR of \$4,000 against leaks and breaks in the customer-owned water service line between the customer's house and the Company's

meter. The leaks or breaks must be caused by “normal wear and tear.” The sewer line insurance program insures against clogs and blockages in the customer’s portion of the sewer line and would cost \$108 per year. The charges would appear on the customer’s Arizona American bill. S-5, pp. 2-3.

II. The proposed service is contrary to the public interest, and the Application should be denied.

Arizona American has not shown that the Agreement is in the public interest. In general, affiliate transactions raise the concern of self-dealing where market forces do not necessarily drive prices. Also, utilities have a business incentive to shift costs from non-regulated competitive operations to regulated monopoly utility services with captive ratepayers. S-5, p. 6, citing *NARUC Guidelines for Cost Allocations and Affiliate Transactions*¹. Although not every affiliate transaction poses the same degree of risk; unnecessary risk to ratepayers should be avoided if the public interest is not served. Arizona American has not shown why the Programs could not be offered by its affiliate AWR without the promotional assistance of Arizona American under the Agreement. Without a compelling public interest to have the Programs available to customers in the manner proposed by the Application, there does not appear to be a compelling interest to approve the Application. Therefore, Staff recommends that the Application not be approved.

III. If the Application is approved, Staff’s proposed conditions should be adopted.

The primary beneficiary of the Programs would be AWR as it will likely profit substantially from the successful Programs. Staff acknowledges that Arizona American’s rate payers may also be able to benefit from a successful program. If the price for all the services Arizona American provides to AWR is set at an appropriate level, and the net income from those services is included above-the-line for ratemaking purposes, the Programs could result in the lower revenue requirement in Arizona American’s next rate case. A lower revenue requirement translates into lower rates for customers. In addition, there will be some customers who enroll in the Programs who may benefit when they have a coverage claim for water or sewer line leaks or breaks. For some customers, the Programs may ultimately prove economical. S-5, p. 18.

¹ Developed by NARUC Staff Subcommittee on Accounts (1998).

1 If the Commission determines that the Agreement is in the public interest and approves the
2 Application, safeguards to protect customers should also be approved. Thus, Staff requests that the
3 Commission adopt certain conditions and requirements. The conditions and requirements address,
4 among other issues, privacy concerns, appropriate compensation for Arizona American services, the
5 initial life of the Agreement and rate case treatment of income from those services. During the
6 course of these proceedings most of Staff's conditions have been agreed to by Arizona American and
7 AWR ("the Companies"). Where disagreement continues, the issues will be discussed subsequently.

8 *Condition No. 1:*

9 *A requirement that the Agreement be modified to indicate that Arizona*
10 *American should be compensated for its services at 115 percent of fully*
11 *allocated costs or prevailing market prices, whichever is higher, and that at*
12 *its next rate case, Arizona American should provide information and*
13 *workpapers showing the calculation of the market price and fully allocated*
14 *costs. This method would apply to all costs including billing and collecting*
15 *and replace the \$0.10 per bill amount.*

16 **Condition No. 1** – This Condition relates to appropriately compensating Arizona American
17 for its participation in providing the services. Arizona-American proposes that it be compensated at
18 \$0.10 per bill for direct cost plus 115% of all fully allocated costs additionally incurred by Arizona-
19 American. This is the same compensation of most Arizona American's affiliates in other states
20 where the program is offered. (Tr. at 45). Arizona American's \$0.10 figure for direct costs is
21 without support in the record. Arizona-American was unable to give any explanation to support this
22 figure. (Tr. at 28-32 and 51; Staff Exhibit S-7 at Response 1-19). Staff proposes that Arizona
23 American be compensated at the higher of market cost or 115% of fully allocated cost for direct
24 costs. Staff's Witness, Ms. Jaress, testified that market information, where available, is the best
25 measure of fair compensation to Arizona American. (Tr. at 137). Condition One also requires that
26 Arizona American provide relevant cost information during its next rate case. (Tr. at 114).

27 *Condition No. 2:*

28 *The Commission should require Arizona American, before disseminating*
customer-specific information to an affiliate or non-affiliate, to inform the
customer regarding what information would be released and for what
purpose. The customer must affirmatively respond before such information is
disseminated. Non-response by the customer should not be considered

1 *consent. This requirement should not apply to requests from police agencies*
2 *or subpoenas.*

3 **Condition No. 2** – This condition is agreed upon inasmuch as Arizona American has stated it
4 will not provide customer information or marketing services to AWR. Rebuttal Testimony of Linda
5 Jaress, Staff Exhibit S-6, p. 4, Tr. at 92.

6 *Condition No. 3:*

7 *A requirement that the Agreement be modified to omit Section 6.1.4 and any*
8 *other section that might allow Arizona American and AWR to contract for*
9 *additional services other than those specifically related to the water and*
10 *sewer line Programs.*

11 **Condition No. 3** – This condition has been agreed upon. Tr. at 92; S-6, p. 4; S-4; A-2.

12 *Condition No. 4:*

13 *A requirement that any net income derived by Arizona American from the*
14 *services it provides AWR for the Programs be considered above-the-line for*
15 *ratemaking purposes.*

16 **Condition No. 4** – This condition has been accepted by the Companies. Tr. at 93; S-
17 6, p. 4.

18 *Condition No. 5:*

19 *A requirement that Arizona American not endorse or promote the Programs*
20 *and that the Agreement be modified to so reflect.*

21 **Condition No. 5** – This condition has been accepted by the Companies. Tr. at 93; S-
22 6, p. 4; S-4; A-2.

23 *Condition No. 6:*

24 *The initial life of the Agreement should be limited to three years. Extensions*
25 *of the Agreement should be approved by the Commission.*

26 **Condition No. 6** – At the hearing, Arizona-American proposed modifying the termination
27 date of the Agreement. Under its new proposal, Arizona-American will be required to file for re-
28 approval of the Agreement after collecting three years of data. Staff agrees that Arizona-Arizona's
hearing proposal is within "a range of reasonableness." (Tr. at 119).

29 *Condition No. 7:*

30 *The Commission reserves the right to examine the books and records of AWR*
31 *in connections with the Programs.*

32 **Condition No. 7-** This condition has been accepted by the Companies. Tr. at 94-95;
33 S-6, p. 5.

1 *Condition No. 8:*

2 *The Agreement should be modified to include a definition of fully allocated or*
3 *fully distributed costs as including direct costs, a contribution to common*
4 *costs, and overhead.*

5 **Condition No. 8** – This condition has been accepted by the Companies. Tr. at 95; S-6, pp.5-
6 6, 5-4: A-2.

7 *Condition No. 9:*

8 *Arizona American and RWE should be ordered to file for appropriate waivers*
9 *of the Rules.*

10 **Condition No. 9** – This condition would require Arizona-American to file for a waiver of the
11 Commission’s Holding Company and Affiliated Interest Rules A.A.C. Article 8, R14-2-831 et seq.
12 (“Rules”), so as to clarify any ambiguity regarding the application of these Rules to Arizona-
13 American’s affiliates and ultimate corporate parent, RWE.

14 The ALJ asked for briefing on the applicability of the Rules. The Rules require that a utility
15 or affiliate “intending to organize a public utility holding company or reorganize an existing public
16 utility holding company” must file a Notice of Intent with the Commission. A.A.C. R14-2-803(A).
17 The Rules define “holding company” as any “affiliate that controls a public utility”. A.A.C. R14-2-
18 803(4). The rules also define “affiliate” and “reorganize” very broadly. A.A.C R14-2-803(1) and
19 (5). Thus, the Rules could conceivably apply to a number of RWE’s activities.

20 The Commission has power to enact rules requiring information regarding, and approval of,
21 all transactions between public service corporations and their affiliates that could significantly affect
22 economic stability and thus impact rates charged by public service corporations. A.R.S. Const. Act.
23 15. § 3. Arizona Corporation Commission v. State ex rel Woods, 171 Ariz. 286, 296-297, 830 P.2d
24 807, 817-818 (1992). It is not up to the public service corporation or its affiliates to determine
25 unilaterally whether the Rules apply to a particular organization or reorganization of a public service
26 company’s parents and affiliates. Id. Further, whether the Arizona public service corporation’s parent
27 or affiliates are Arizona corporations does not alter the Rules’ application. It is the parent’s or
28 affiliates’ relationship to the Arizona public service corporation that is the nexus of the Commission’s
 jurisdiction over the public service corporation’s transactions with its parent or affiliates. Id. at 299,
 820.

1 Arizona American and its parent and affiliates are not the first companies to face this
2 problem. Other companies have obtained waivers from the Commission that clarify the applicability
3 of the Rules, and where appropriate, permit waivers of the application of the Rules. For example, in
4 Commission Decision No. 58164 (1993), the Commission granted compliance waivers of certain
5 Rule provisions to Citizens Utilities Company. Later, Citizens' Arizona water and waste water
6 operations were acquired by Arizona American. Decision No. 63584 (2001) approved the
7 acquisition, but the decision does not specifically preserve for Arizona American the waivers granted
8 to Citizens. However, nothing in Decision No. 63584 appears to preclude Arizona American from
9 filing a waiver request at this time. Arizona American, its parent or affiliates may consider filing
10 such a waiver(s) request. Until such time as a request for waiver(s) is filed and considered by the
11 Commission, there does not appear to be an adequate explanation in this record why the Rules do not
12 apply to organization and reorganization of Arizona American's parent and affiliates.

13 *Condition No. 10:*

14 *Staff recommends that the Agreement be modified to include payment by*
15 *AWR to Arizona American for use of its customer list.*

16 **Condition No. 10** – Arizona American has decided not to provide customer lists to AWR,
17 making this recommendation moot.

18 **IV. Analysis of Revised Promotional Materials.**

19 Staff has reviewed the new promotional materials submitted by Arizona American after the
20 hearing. In Staff's view, the promotional materials' disclaimers that the Programs are not being
21 offered by Arizona American, need to be highlighted in **red** and **in a font at least as large as the**
22 **promotional statements** presented by the Company in Exhibits A-3 and A-4.

23 **V. Conclusion.**

24 Although the two Companies' agreed upon modifications to the Agreement greatly reduce
25 Staff's concerns about Arizona American's participation in the provision of the Programs, Arizona
26 American has not established a need for the Programs or shown that Arizona American's
27 participation is necessary and in the public interest. Thus, Staff continues to recommend denial of the
28

1 Application. If the Commission approves the Application, Staff recommends that the Commission
2 adopt Staff's conditions as discussed in this brief.

3 RESPECTFULLY SUBMITTED this 23rd day of September 2005.
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11 The original and thirteen (13) copies of the
12 foregoing were filed this 23rd day of
13 September 2005 with:

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